

REFERENCE: □
ORGANISATION: □ □
CATEGORY:

005
EUAN RAMSEY ASSOCIATES
BUSINESS

Response to Scottish Government consultation

“Better value from housing association grant”



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1. Introduction

- 1.1. In this response I will discuss the impact of the proposed changes, the fundamental limitations of the HAG funding model, the financial strength of the RSL sector and alternative funding mechanisms. The fundamental questions raised by this consultation are
- 1.2. Do we accept that each development should be financially self sustainable, based on affordable rents with rental growth aligned to increases in housing costs (rather than RPI)?
- 1.3. Should we accept that rental growth should be higher than cost increases to enable an increase in the scale of social housing provision without an increase in the overall level of grant funding? This may require an understanding or guarantees from government that they will not attempt to restrict rent increases either directly or through capping housing benefit.
- 1.4. Or do we accept that development in the future will be restricted to organisations with the resources to cross subsidise either from income from existing activities or from reserves?

2. Impact of Proposed Changes

- 2.1. The major proposed change is the increase in the rental growth assumption from RPI only to RPI plus 1%. This will change the way the private finance is calculated and instead of having a constant value for the loan multiplier which is applied to the “net income” to calculate the loan a different multiplier will be applied to income and costs. This means the loan multiplier in the traditional sense will vary according to the rent level. There is an example at [appendix 3](#). Without going into technicalities the effect for a newbuild house costing £100k with a rent of £3k would be to increase the loan from £30k to £40k an increase of 33% with an effective loan multiplier of 23.64. I have tabulated a comparison for a £100k newbuild property at various rent levels at [appendix 1](#). This will allow an increase of 17% in the number of new houses being built without any increase in total grant.
- 2.2. At current levels of private finance many RSL’s are having difficulty with funders security valuations on an “existing use basis” not matching the levels of private finance required. Some are using valuations such as “existing use with sales” and “market value tenanted” to access private finance. This indicates that the level of private finance required exceeds the value of these properties when used for social renting. The increase in private finance generated by the proposed changes can only exacerbate the situation. It is also likely that funders will perceive these investments as higher risk with

higher gearing and combined with the widely discussed credit crunch is likely to lead to higher lenders margins and increases in funding costs.

- 2.3. This is likely to consolidate grant funded development with large, resource rich developers who can either fund development from their own reserves, from cross collateralisation of unencumbered stock or who can cross subsidise newbuild with rent from other properties.

3. Fundamental Limitations of existing HAG funding model

- 3.1. I have examined the level of allowances against Communities Scotlands own financial digest which compiles financial statistics on RSL's based on published annual accounts. The most recent figures relate to accounts for year ending 31 March, 2006 and I have applied an uplift of 7% to these as a good approximation for RPI in the two intervening years.

comparison of allowances to Communities Scotland RSL Financial Digest			
Based on stats for ye 31 March, 2006 (most recent available)			
inflated by 7%			
Used allowances for 1000-2500 units newbuild			
comparison to lower quartile and median in digest			
	allowances	lower quartile	median
management	312	761.84	923.41
maintenance	450	265.36	362.73
planned repairs	510	207.58	387.34
	1272	1234.78	1673.48
% of allowances		97%	132%

- 3.2. From the above table it can be seen that although there are significant discrepancies between individual classifications in total the level of allowances is broadly equivalent to the reported costs for RSL's at the lower quartile and the costs for median performers are around 30% higher than the allowances.
- 3.3. Unit costs for planned repairs seems very low when compared to the values being derived from some stock condition surveys which suggests expenditure over thirty years of between £20k-£30k per unit which would provide an annual unit cost inclusive of fees and VAT of between £666 and £1000 per unit. This does not seem to be supported by either allowances or by the actual levels of expenditure on planned repairs. It would be expected that the impact of the Scottish housing Quality Standard would increase this

expenditure. An in depth review is required to explain the large discrepancy between these figures.

- 3.4. It is suggested in the consultation that management and maintenance costs for newbuild housing are lower than for the sector as a whole although this is not quantified. Intuitively one would tend to agree with this. However, new development is evaluated over thirty years and it would be expected that over an extended period costs and voids levels would reflect the profile of the sector as a whole.
- 3.5. The second area I want to examine is the assumption in the model that costs increase by retail price index (RPI) only. Intuitively, we would expect housing costs to rise at more than RPI since they are essentially driven by staffing costs (both the housing providers own staffing costs and those of maintenance contractors) which would tend long term to rise above inflation. Earnings indices tend to show that labour costs rise at around the same rate as GDP which recently has been in excess of 2% in real terms or RPI plus 2%. The RPI is an average over a whole economy and is artificially depressed by the benefits of globalisation and the availability of cheap imports from new economies which have little impact on the costs of housing providers.
- 3.6. I would draw your attention to Communities Scotlands own statistics. On page 15 of the Financial Digest 2005-2006 we are advised that “since 2001/02 the median cost has increased from £657 per house to £863 per house...allowing for inflation this represents a real terms increase...of 4.3% annually.” This relates to management costs and my own view is that this overstates the position and doesn’t take account of the inclusion of Glasgow Housing Association(GHA) in the annual figures from 2003 with their reportedly high management costs. However my own research which excludes the impact of GHA suggests that unit costs are rising in real terms by around 2% per annum. The comparative figures for planned maintenance and reactive maintenance from the Digest show increases in unit spend of around RPI plus 10%. Again these will be distorted by the scale of GHA but the general trend of costs rising above inflation can be supported by a large body of evidence.
- 3.7. . The proposals for 2008/09 suggest long term funding costs of 6% and RPI inflation of 3%. This long term interest rate is not far removed from current rates. Most RSL’s at this time with bank base at 5.25% can probably access variable rate funding at around 5.8% inclusive of lenders margin although with recent market volatility if loans are Libor denominated then costs may be significantly higher. At 5 March 3 month libor was at 5.77%. There is no allowance for arrangement fees, legal and valuation costs which can be substantial. RPI is currently (Dec 2007) at 4% although this is perceived as high. The implicit long term “real” (the cost of funds less inflation) funding

cost of 3% seems reasonable. This is the implicit discount factor¹ in the model.

- 3.8. The discount rate takes no account of risk which is substantial when projecting over a thirty year period. Treasury Guidance has suggested that an appropriate risk factor for private sector projects is 2%.
- 3.9. The timing and phasing of expenditure is often critical in evaluating such projects particularly in relation to major repairs expenditure. The current model takes no account of this and extrapolates a notional set of values evenly over a thirty year period.
- 3.10. The model produces an anomaly. At the margin an additional £1000 added to rent will generate an additional £22k of loan funding which will require annual loan repayments of £1,580 based on a loan at 6% over thirty years. It will take until year 13 for the rent to grow to the same level as the loan repayment. Due to accumulated cash deficits and rolled up interest funded at higher overdraft rates (assumed at 7%) rather than at mortgage rates the accumulated deficit will continue rising until year 21 when it peaks at over £9k and by year 30 there is still an accumulated deficit of almost £4k. ([appendix 2](#))
- 3.11. In the consultation document it is suggested that average secure rents have risen by RPI plus 2% over the last 5 years. I would suggest that the inclusion of GHA from 2003 with higher rents than most other RSL's would explain this apparent inflation. If we were comparing it on a like for like basis, and given the commitment of many stock transfer landlords to RPI only increases, the true figure is probably somewhere between RPI and RPI plus 1%.
- 3.12. By now you may be wondering how we have managed to work with such a dysfunctional model for such a long time. The answer is quite simple. Where the model assumed rental growth of RPI only, independent appraisals and security valuations would assume RPI plus 1% to compensate for the deficiencies of the model and to arrive at a broadly similar level of private finance.

¹ Discount Factor-This is the rate used to discount future cash flows to arrive at a "net present value" which is equivalent to the private finance requirement. In simple terms if you anticipate having a cash sum of £110 in a years time and the rate of interest is 10% then the "net present value" of £110 is £100 ie a rational individual would be indifferent between having £100 today or £110 in a years time. If inflation was 5% then the "real" discount rate would be 5%. Essentially the higher the discount rate used the lower the net present value or level of private finance. In any 30 year cashflow projection there is an element of uncertainty or risk and this is usually reflected in the model by increasing the discount factor to make an allowance for risk. Treasury guidance has suggested that an appropriate factor for risk in private sector projects is 2%. Thus in the above example the discount factor would be 5% plus 2% ie 7%.

4. Financial Position of the sector

- 4.1. There are several references in the consultation to the financial strength of the sector with the implicit assumption that RSL's have the ability to subsidise new development from their reserves.
- 4.2. At a time when rents have been rising at less than RPI plus 1% and unit costs have been rising at around RPI plus 2% this has led to a significant deterioration in RSL's operating position and a level of net surplus which is barely able to sustain the commitment to meet capital repayments on loans. Hardly an indicator of the claims of financial strength described in the consultation. In Communities Scotland's own appraisal of the sector based on 2005-06 accounts the opening remarks tell us "the operating surplus reduced... to the lowest level in recent years" and "the sector recorded its first net deficit".
- 4.3. A large proportion of the reserves built up by RSL's are designated reserves which are required to pay for future major repairs.
- 4.4. Reserves may not be cash backed although it may be an indicator of capacity for additional borrowing.
- 4.5. Funding new development from reserves is not financially sustainable and can only continue until those reserves become diminished.
- 4.6. Diminishing reserves will reduce the financial strength of the sector, may lead to a perception of higher risk by funders and combined with the well publicised credit crunch is likely to lead to an increase in long term funding costs.

5. Alternative Funding Models

- 5.1. It seems obvious that the aim of the consultation is to try and build 17% more houses with the same level of grant. It seems unrealistic that this can be achieved without significant rental growth above RPI inflation.
- 5.2. Now we could suggest that a credible model should be used to evaluate these projects. It would be based on a 30 year discounted cash flow model which recognised the reality of "real" cost increases in the sector, which took a long term view over a thirty year period, which used realistic assumptions for cost and which takes account of the risk involved for RSL's. In order to achieve the levels of private finance suggested in the consultation we would probably need to assume rental growth of around 3-4% above RPI. I suspect that this will not be politically acceptable.

- 5.3. An alternative would be to dispense with the model and introduce a regime where land and site preparation is 100% grant funded with an additional fixed amounts of grant per unit varied to take account of property sizes and higher costs in rural areas. This would then incentivise the developer to manage costs effectively and it would allow landlords in consultation with tenants the freedom to specify a particular standard of development and set a rent appropriate to cover their costs and repay loan funding. A slightly different version of this model would pay a fixed percentage of cost.

6. Conclusions

- 6.1. There is strong evidence that cost growth is already outstripping growth in rental income in the sector, that surpluses are declining and that RSL's are already cross subsidising new developments from existing property portfolios and / or reserves.
- 6.2. Cost growth in the sector is running at around RPI plus 2% per unit per annum.
- 6.3. The current proposal would require rental growth of RPI plus 3-4% if new development is to be financially sustainable.
- 6.4. Increased loan funding and increased financial gearing will lead to increased funding costs.
- 6.5. The proposal is likely to further concentrate development with larger organisations which have the capacity to cross subsidise new build from other properties, activities and/or reserves.
- 6.6. The methodology and assumptions underpinning the calculation of loans and grants must be realistic to protect the financial health of the sector and if the model is to have any credibility.
- 6.7. The proposal will increase new house building by around 17% without any increase in public subsidy.
- 6.8. The sector may want to consider increasing use of organisational models which attempt to incorporate the advantages of small community based organisations but utilise development and financial advantages of larger groupings.
- 6.9. There is a trade off between levels of grant and rent. The solution will depend on whether it is deemed more important to increase the scale of new house building or to keep rents low. From a fiscal point of view the decision is whether housing subsidies should be realigned between capital grant and housing benefit.

Appendix 1 Effect of proposal on value of loan

rent	old system			Grant %
	loan	loan multiplier	loan %	
2,500	21,365	18.1369	21.4	79.6
2,750	25,808	18.1369	25.8	74.2
3,000	30,252	18.1369	30.3	69.7
3,250	34,696	18.1369	34.7	65.3
3,500	39,139	18.1369	39.1	60.9
3,750	43,583	18.1369	43.6	56.4
4,000	48,026	18.1369	48	52

rent	proposed new system				increase in loan %
	loan	loan multiplier	loan %	Grant %	
2,500	29,375	24.418	29.4	71.6	37.5%
2,750	34,760	23.96	34.8	65.2	34.7%
3,000	40,146	23.64	40.1	59.9	32.7%
3,250	45,531	23.4	45.5	54.5	31.2%
3,500	50,917	23.2	50.9	49.1	30.1%
3,750	56,303	23.07	56.3	43.7	29.2%
4,000	61,688	22.95	61.7	38.3	28.4%

These calculations are based on a new build property costing £100k and the allowances are based on an organisation with between 1000 and 2500 properties.

Appendix 2 Impact of additional rent of £1k

year	opening cash	rent	loan	close cash	interest	net cash
1	0	1,000	(1,581)	(581)	(20)	(601)
2	(601)	1,040	(1,581)	(1,142)	(61)	(1,203)
3	(1,203)	1,082	(1,581)	(1,702)	(102)	(1,804)
4	(1,804)	1,125	(1,581)	(2,260)	(142)	(2,402)
5	(2,402)	1,170	(1,581)	(2,813)	(183)	(2,996)
6	(2,996)	1,217	(1,581)	(3,360)	(222)	(3,582)
7	(3,582)	1,265	(1,581)	(3,898)	(262)	(4,160)
8	(4,160)	1,316	(1,581)	(4,425)	(300)	(4,725)
9	(4,725)	1,369	(1,581)	(4,937)	(338)	(5,275)
10	(5,275)	1,423	(1,581)	(5,433)	(375)	(5,808)
11	(5,808)	1,480	(1,581)	(5,908)	(410)	(6,318)
12	(6,318)	1,539	(1,581)	(6,360)	(444)	(6,804)
13	(6,804)	1,601	(1,581)	(6,783)	(476)	(7,259)
14	(7,259)	1,665	(1,581)	(7,175)	(505)	(7,680)
15	(7,680)	1,732	(1,581)	(7,529)	(532)	(8,061)
16	(8,061)	1,801	(1,581)	(7,841)	(557)	(8,398)
17	(8,398)	1,873	(1,581)	(8,106)	(578)	(8,683)
18	(8,683)	1,948	(1,581)	(8,316)	(595)	(8,911)
19	(8,911)	2,026	(1,581)	(8,466)	(608)	(9,074)
20	(9,074)	2,107	(1,581)	(8,548)	(617)	(9,165)
21	(9,165)	2,191	(1,581)	(8,555)	(620)	(9,175)
22	(9,175)	2,279	(1,581)	(8,477)	(618)	(9,095)
23	(9,095)	2,370	(1,581)	(8,306)	(609)	(8,915)
24	(8,915)	2,465	(1,581)	(8,031)	(593)	(8,624)
25	(8,624)	2,563	(1,581)	(7,642)	(569)	(8,211)
26	(8,211)	2,666	(1,581)	(7,126)	(537)	(7,663)
27	(7,663)	2,772	(1,581)	(6,471)	(495)	(6,966)
28	(6,966)	2,883	(1,581)	(5,663)	(442)	(6,105)
29	(6,105)	2,999	(1,581)	(4,688)	(378)	(5,065)
30	(5,065)	3,119	(1,581)	(3,528)	(301)	(3,828)
total		56,085	(47,425)		(12,488)	

Appendix 3 Old v New HAG Calculation

Example of old v new calculation			
Used allowances for 1000-2500 units newbuild			
current			proposed
rent	3000		3000
voids	-60		-30
net rent	2940		2970
management	312		312
maintenance	450		450
planned repairs	510		510
total costs	1272		1272
net income	1668		1698
loan multiplier	18.1369		23.64328
income multiplier			21.76
cost multiplier			19.246
loan	30252.35		40146.29
%	30.3%		40.1%
increase			32.7%
grant	69747.65		59853.71
%	70%		60%
cost	100000		100000

Under the proposed new system there are effectively two multipliers. The income multiplier is applied to the “net rent” and the cost multiplier is applied to the total costs. The value of the loan is the difference between these figures ie loan = (net rent x 21.76)-(total costs x 19.24). Under the current system the loan =(net income x 18.1369)